IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMERA BLUE CROSS AND ITS AFFILIATES

Washington State Insurance Commissioner's Docket # G02-45

REPORT OF

Towers Perrin

SUPPLEMENT TO

Review of Premera's Executive Compensation Program

March 5, 2004

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INTRODUCTION

At the request of PREMERA, Towers Perrin has reviewed the amendments to the Company's Form A, including Exhibits G-10 and E-8 filed on February 5, 2004, and the Report Addendum prepared by PriceWaterhouseCoopers, dated February 27, 2004, and entitled "PREMERA's Executive Compensation Review Summary of Issues – Resolved or Pending". We also have comments on the Supplemental Reports and Letter from another OIC Consultant, Cantilo & Bennett.

Towers Perrin's findings and conclusions in our Review of PREMERA's Executive Compensation Program of November 2003 have not been changed materially by the PREMERA amendments.

Our overall observation is that the constraints on executive compensation to which PREMERA has agreed are highly conservative, and will considerably limit the ability of the Company and its directors to administer a competitive executive compensation program. We also observe that with one possible exception, the recommendations made by PriceWaterhouseCoopers in their Report Addendum would not be in the best interests of the Company from the viewpoints of policyholders, healthcare providers, future shareholders, and other constituents.

A. PwC REPORT ADDENDUM: FEBRUARY 27, 2004

The following section of our report is organized so as to address each of PwC's recommendations individually. We have not addressed those issues where PwC raises no concerns.

Issue # I-1: Long-Term Incentive Payout Determination (Page 3)

PwC Recommendation: "Long-term incentive payouts should be based on salary levels in effect at the time of the award/grant and NOT at the time of payout." The major rationale cited is compliance with IRC Section 162(m), not a reduction of PREMERA's target compensation.

Towers Perrin Observations: As a non-public company, PREMERA is not now subject to IRC Section 162(m) of the Internal Revenue Code. However, PwC's concern regarding compliance with Section 162(m) can be readily addressed by specifying a maximum dollar amount at the outset. We observe that using starting salary to define the LTIP payout is simpler from an administrative point-of-view.

We also note that if starting salary is used rather than ending salary, and assuming annual salary increases, awards will most likely be lower unless percent-of-salary targets are increased. We found in November that PREMERA's total compensation was competitive with market levels, and PwC raises no concerns regarding planned levels post Conversion; therefore there is no reason to reduce long-term incentives.

Towers Perrin Recommendation: We recommend either that maximum dollar awards be specified to comply with IRC Section 162(m) when applicable, or that beginning salary be used, along with a corresponding increase in target awards as a percent of salary, in order to maintain competitive compensation levels.

Issue # I-2: Voluntary Turnover (Page 4)

PwC Status: "Board belief not substantiated by data."

Towers Perrin Observations: Based on survey data from Watson Wyatt's 2003/2004 Insurance Industry Compensation Planning Report, total turnover (voluntary and involuntary) rates in the health/annuity/and life insurance industry for exempt personnel (e.g., management) are 10%, and for non-exempt staff 11%. We understand that PREMERA's officer turnover rates have been 14.93% for 2000-2002, and 16.67% for 2001-2003, considerably greater than market levels. We also note that because public companies generally include a greater number of executives in a long-term incentive plan than do non-public companies, and because long-term incentive plans generally provide for forfeiture of awards in the event of voluntary termination, the Board of Directors (the “Board”) would have access to an additional tool to promote retention of the Company’s officers following a public offering. In any event, we understand that retention was not a factor in the decision to pursue the Conversion.

Issue # I-3: Incentive Funding/Goal Setting – Annual Plan (Page 4)

PwC Recommendation: “…establish minimum performance goals that take into account prior years’ performance results and management’s expectations of next year’s performance.” This is based on PwC’s belief that the minimum performance goals are “understated” vs. actual and historical results and budget.

Towers Perrin Observations: PwC continues to misstate or misinterpret the PREMERA Annual Incentive Plan. PREMERA’s plan is very conservative in design; it establishes an operating income target and a minimum and maximum around that target. Actual operating income is compared to the range and if actual income is below the minimum, no award of any kind is granted. This result differs from the most commonly used approach to annual incentive plan design, which is to treat various measures independently, and allow a payout in one measure even if performance is below threshold for others.

If actual operating income exceeds the minimum, awards can then be adjusted (downward only) according to performance in areas such as membership, sales and marketing, IT, underwriting, etc. In other words, an initial award is determined according to actual operating profit compared to target, which could be greater or less than the target award. Performance in other areas is then assessed and can adjust the initial award downward if objectives are not met, but cannot increase it.

Because of the plan design, it is entirely appropriate to provide a wider-than-usual range around the profit target in order to increase the probability for *some* payout for performance other than operating income.

Towers Perrin Recommendation: We strongly recommend that no changes be made to the minimum operating income goal setting process.

Issue # I-3: Incentive Funding/Goal Setting – LTIP (Page 4)

PwC Recommendation: "…establish a minimum shareholder return before any payment is triggered."

Towers Perrin Observations: PwC is not clear regarding its definition of shareholder return, which could be financial (e.g., return on equity) or stock-based (e.g., share price increase plus dividends). If the former, we note that the Long-Term Incentive Plan already has a provision for a minimum return to shareholders (expressed as operating income) below which no award is paid out.

If the PwC recommendation refers to share price and dividends, we point out that the option portion (majority proportion) of the post-Conversion plan is structured automatically to have a value only when the shareholders realize a gain.

We also note that the performance measures in the LTIP include several that are not directly related to shareholder return, but are highly relevant to constituents, such as how well the Company serves its members. Further, PREMERA's LTIP, like that of most companies that use such plans in addition to options, contains measures that should lead to share price growth (e.g., membership, service, retention), and which the Company wants to specifically encourage.

Finally, Institutional Shareholder Services (ISS), a leading proxy voting advisory organization, has announced that it will not consider stock-based shareholder return in its consideration of proposals relating to compensation plans in the first three years of public ownership.

Towers Perrin Recommendation: We do not believe that the addition of a "shareholder return" minimum to the LTIP would be in the best interests of PREMERA's constituents, and strongly recommend against it.

Issue # I-4: Performance Measures (Page 4)

PwC Recommendations: "…de-emphasize the impact of non-financial performance measures for SVPs, EVPs and the CEO. A meaningful portion of the annual long-term incentive payout should be linked to the achievement of operating margin goals."

Towers Perrin Observations: Annual incentive plans are usually based on performance measures that management and the board believe best reflect the tasks that should be accomplished in the current year. While these measures are often financial, they may also include other measures that reflect the tasks needed to position the company for the future. Non-financial measures are, we believe, particularly relevant in the health insurance industry, as they represent the primary means to achieve adequate profitability, and include customer satisfaction, membership, retention and growth, service and quality. In our experience in the health insurance industry we observe that about **50%** of the annual incentive plan award for senior officers is determined by non-financial measures, contrary to the PwC assertion.

It should also be noted again that PREMERA's annual incentive plan is structured in a fashion that actually puts more emphasis on financial results than is apparent at first, as explained previously (observations, Issue I-3).

We also note that operating margin is not a common, or particularly informative, performance measure in the health insurance industry. Operating margin is not within the top-10 financial performance measures used for incentive plan purposes according to the Watson Wyatt survey cited above, or the measures identified by Towers Perrin in two surveys of the insurance industry. One major problem with this measure is the changing business mix in the health insurance industry, and the different margin characteristics of various sources of revenue. Each may have a respective margin, and using a single measure might encourage exiting low margin but value-creating businesses.

In most plan designs, achievement of non-financial objectives can be rewarded regardless of achievement of financial objectives. Therefore, PREMERA's plan is conservative compared to market practice.

Towers Perrin Recommendation: Towers Perrin recommends that PREMERA not change its process for establishing performance measures of the annual incentive plan.

Issue # I-5: Deferred Compensation (Page 5)

PwC Recommendation: "…PREMERA [should] implement Mercer's recommendation effective for 2004" to eliminate the match.

Towers Perrin Observation: Under this program, executives are required to defer a portion of their incentive compensation. The Company provides a partial match for the mandatory deferral. This is a multi-year program, and the amount of the match paid out is dependent on continued employment. We determined that compensation delivered by this plan did not lead to total compensation above market. Further, a number of executives already have deferred balances under this program which must still be paid out over several future years, and the Company has committed to match mandatory deferrals applicable for periods prior to the Conversion.

Towers Perrin Recommendation: PREMERA must honor its commitments to match deferrals made prior to the Conversion. We recommend that PREMERA eliminate the mandatory deferral program and corresponding matches on a prospective basis after Conversion.

Issue # I-6: Defined Contribution and Defined Benefit SERP (Page 5)

PwC Recommendation: "Include a provision….such that the aggregate retirement benefit…is offset by qualified retirement benefits," et al.

Towers Perrin Observations: PREMERA's DB SERP does include an offset for the qualified pension plan benefit. To the extent that the DC SERP does not provide an offset for qualified benefits, et al., then the recommended change would reduce overall benefits. As PwC does not state that current benefits are above market levels, we see no reason to change the plan design or to reduce the benefits.

Towers Perrin Recommendation: We recommend that no changes in plan design be made in connection with the proposed Conversion, but that the Compensation Committee of the Board continues to monitor and maintain benefit levels at competitive levels.

Issue # I-7: Change-in-Control ("CIC") – Walk-Away Rights (Page 5)

PwC Recommendation: "limit 'walk-away rights' to the CEO only."

Towers Perrin Observations: In order to put this issue in context, several preliminary points should be made. First, Conversion will not trigger the CIC program. Second, we observe that the commonly used "Constructive Termination" definition in the PREMERA CIC contract provides *full* CIC benefits in the event of a material reduction in the employees' duties and responsibilities, which is highly probable for senior executives in a CIC. Therefore, an executive is more likely to leave under this provision than the "walk-away" clause. We also note that providing only 50% of the original CIC benefits is extremely conservative and unusual. Further, the executive must remain for one year following a CIC to trigger this benefit, which should not only facilitate a smooth transition to a new owner, but also provide the new owner ample opportunity to create an appealing work environment to retain executives, and reduce the likelihood that this clause will come into use.

Finally, we note that CIC protection is provided under individual contracts which would have to be renegotiated.

Towers Perrin Recommendation: We recommend that the individual contracts with each executive not be renegotiated and changed as PwC proposes.

Issue # I-8: Change-in-Control – Enhanced DB SERP (Page 5)

PwC Recommendation: "Exclude severance benefits from Final Compensation in determining the enhanced DB SERP benefit."

Towers Perrin Observations: In a CIC, the PREMERA DB SERP recognizes the severance payments on an annualized basis, and does **not** include the entire benefit in the final year to calculate SERP benefits. In effect, the SERP simply bases retirement benefits on the salary and the *target* bonus in effect during the year in which the CIC occurs, and assumes up to three years at that rate of pay. This could mean, in fact, that the SERP is based on a *lesser* amount than actual annualized pay in the CIC year if actual bonus exceeds target bonus. The following excerpt from a PREMERA agreement details the plan:

Benefits Under the DB SERP

DB SERP*. The Employee's Compensation, as defined under and for purposes of calculating benefits under the DB SERP, shall include the severance benefit payable in accordance with Section 3.1(a), calculated as if paid in monthly installments over the course of the Benefits Continuation Period. The Employer, in determining Final Compensation (as defined in the DB SERP), shall calculate average Compensation over the Employee's Benefits Continuation Period first, considering Compensation for the months preceding termination only as required to constitute a total of 36 months of Compensation. Actual Service, as defined in and for purposes of calculating benefits under the DB SERP, shall include the Benefits Continuation Period. Payments under this Section 3.1(c)(i) shall be paid at the time provided for payment of benefits under the DB SERP.*

Some companies use actual bonus or maximum bonus rather than target, while others use pay in effect on the date of CIC and assume it *increases* for the next 3 years. Compared to these, PREMERA's plan is conservative.

Towers Perrin Recommendation: We recommend that the individual contracts with each executive not be renegotiated and changed as PwC proposes.

Issue # II-1: Long-Term Incentive Plan Continuation (Page 6)

PwC Recommendations: "…establish a minimum shareholder return before any LTIP incentive payment is triggered."

Towers Perrin Observations: We believe that it is not wise to establish additional shareholder return requirements for reasons previously stated. PwC apparently bases this recommendation on their observation that cash or stock-based incentive plans are "not prevalent" in PREMERA's public company peer group, especially in IPO situations. PREMERA is in a different situation because it is subject to more severe restrictions on option grants than are its peer companies, and share utilization of the peer companies is substantially higher as a percent of total shares. In fact, PREMERA must continue the LTIP in order to provide competitive total compensation because of these restrictions.

Further, we observe a trend in recent years to reduce the percentage of compensation delivered through options. This trend may not be observable in currently available proxy statements, as most show 2002 awards. However, 2003 custom surveys reflect the trend and show that 47% of general industry companies grant options along with another plan and 82% of major life insurance companies grant options along with cash or stock plans. The median value of options vs. total long-term awards for a representative senior executive is 57% for insurance companies with 2 or more plans.

Finally, the Company intends to use restricted stock as payment for the LTIP, which would enhance the emphasis on shareholder return.

Towers Perrin Recommendation: We recommend that no change be made to the LTIP.

Issue # III-1: Long-Term Incentive Plan Mix (Page 8)

PwC Recommendations: "…Establish a minimum shareholder return before any incentive payment is triggered. This ensures an appropriate pay and performance relationship exists, on behalf of the shareholders and the OIC."

Towers Perrin Observations: As mentioned in our response to Issue II-1, a trend of recent origin has been to reduce the percentage of compensation delivered through options. 2003 custom surveys reflect the trend and show that 47% of general industry companies use another plan along with options and 87% of major life insurance companies use other plans with options. Options represented 57% of total awards for companies with 2 or more plans.

Also mentioned previously, PREMERA's LTIP contains measures that are highly relevant not only to shareholders (e.g., operating income) as they represent financial measures that may have an impact on share price, but also to other PREMERA constituents (e.g., service).

The latest peer group information is from 2003 proxies reflecting long-term incentive plan data generally of early 2002.

Towers Perrin Recommendation: We do not believe that the addition of a "shareholder return" minimum to the LTIP, or a lower proportion of LTIP versus stock options would be in the best interests of PREMERA's constituents, and we strongly recommend against it.

Issue # III-2: Long-Term Incentive Award Opportunities (Page 8)

PwC Recommendations: "…Limit salary increases to verifiable market rates of percentage increases to executive salaries."

Towers Perrin Observations: PwC raises concerns regarding long-term incentive compensation. Without explanation, PwC recommends limiting salary increase to mitigate these concerns. Towers Perrin observes that PwC ignores

PREMERA's historically low positioning vs. competitive levels regarding total compensation. To the extent that post-Conversion compensation may increase, such increases would be through performance-based, at-risk compensation. Any value delivered from options would occur only as a result of increases in stock value, which would similarly increase value for all shareholders including the Foundations.

Limiting salary increases would, we believe, create an unnecessary constraint on the board as it administers the overall program (level and mix among elements) to provide compensation appropriate to PREMERA and within the bounds of prudence, shareholder scrutiny, and plan design.

Towers Perrin Recommendation: We recommend that no *a priori* rule be imposed limiting salary increases which would in effect further limit the exercise of judgment by the Board over executive pay within the boundaries already constraining its discretion.

Issue # III-3: Officer Base Salary Increases (Page 9)

PwC Recommendations: "…Limit salary increases to verifiable market rates of percentage increases to executive salaries."

Towers Perrin Observations: We have two concerns with the recommendation proposed by PwC. The first is that such a restriction ignores the incumbent-specific circumstances that could require salary increases outside the limited range suggested, e.g., an internal promotion may imply a substantially lower-than-target base salary at the outset, such that market rate increases would never bring the incumbent to target base salary levels. Any attempt to create performance-based distinctions in annual salary increases among the officers would be frustrated by the PwC proposed cap on increases.

The second concern is that the PwC proposal also ignores the position of PREMERA's target total direct compensation (TDC) levels versus the market.

Because the annual and long-term incentives at PREMERA are set as a percentage of base salary, an attempt to bring incumbents to target while maintaining the pay mix would also be thwarted by this restriction.

Towers Perrin Recommendation: We recommend that no *a priori* rule be imposed limiting salary increases which would in effect further limit the exercise of judgment by the Board of Directors over executive pay within the boundaries already constraining its discretion.

B. OTHER OBSERVATIONS ON THE AMENDED FORM A

This section of our report addresses certain aspects of the compensation program that PREMERA has agreed to in its amended Form A. We point out how this program is more restrictive than those of other Blue Cross organizations that have converted recently to public ownership, and also demonstrate that the exercise of judgment by PREMERA's Board should not be further restricted.

1. **Limited annual total share grants for the company over the "stock restriction period" (total of 36 months).**

   None of the recent Blues Conversions contained restrictions as to how many shares can be granted in any particular year, although all had total authorized shares for the equity incentive plan.

   The PREMERA restriction (i.e., no more than 1.67% of shares outstanding per year) is not seen in other stock plans reviewed. This type of restriction is typically not imposed, so that a board of directors can approve the size and timing of plan allocations and exercise judgment over the most effective program design to match prevailing competitive or economic circumstances.

2. **Specific share grants for the CEO and the four EVPs over the "stock restriction period" (total of 36 months).**

   The recent Blues' Conversion plans used a conventional restriction to limit the maximum shares that can be granted to <u>any</u> individual in a plan year. These are in place primarily to meet exchange listing and 162(m) requirements for publicly traded companies.

Further restriction on the share allocations among the officers may well hamper succession planning efforts or retention grants to this group for the following reasons:

- Many companies specifically use ownership participation as a signal to designated succession candidates.
- Similarly, companies need to be flexible to provide retention grants when key individuals (often the senior level management) are being recruited for leadership positions at competitors.

This restriction does not allow for substantial distinctions within this group to be made when deciding on the allocation of compensation. This is more important for equity-based versus cash compensation because the vesting conditions can be tailored to the strategic needs of the Company. For example, the Company can make compensation contingent upon service through a strategic initiative or successor selection process. Additionally, the final value of an equity-based award is tied to the company's results over the critical period.

3. Limited share grants per employee for the "Reserve Pool"

The recent Blues' Conversion plans are silent on additional grant restrictions to employees in addition to the maximum to any individual in a plan year.

C. FEBRUARY 27, 2004 LETTER AND SUPPLEMENTAL REPORT OF CANTILO & BENNETT, L.L.P.

The Cantilo & Bennett Letter and Supplemental Report raise several issues related to executive compensation, which we discuss below. They do not change our previous observations and conclusions. Cantilo & Bennett's statements and our comments are as follows:

1. Final Report Conclusion # 27 (Letter Page 18)

Cantilo & Bennett raises the subject of management turnover rates and assert that PREMERA's turnover rate has been more favorable than that of comparable companies. They then suggest that if turnover is not a problem, perhaps the reason for the Original Transaction is to "enrich recipients" at the expense of "insureds and the public."

Towers Perrin Comment:

As PREMERA has shown, supported by market data from Towers Perrin, PREMERA's management turnover rate has been *higher* than market levels. Further, as we stated earlier, we understand that retention was not a factor in the decision to pursue the Conversion.

2. Negative Financial Impact for Subscribers (Report Page 44)

Cantilo & Bennett suggests that upon Conversion, New PREMERA may experience pressure from shareholders to increase profitability by increasing operating margins with "adverse consequences" for subscribers, policyholders, and the public.

Towers Perrin Comment:

Cantilo & Bennett's observations contradict PwC's compensation consultant who wants to *increase* the emphasis in PREMERA's incentive programs on operating margins and shareholder return. We believe that PREMERA's post-Conversion incentive plans maintain a healthy balance in the incentive plan between financial and non-financial business goals for the Company.

3. Self-Dealing and Conflicts of Interest for PREMERA's Officers and Trustees (Pages 52-60)

Cantilo & Bennett discusses the subject of executive compensation in the context of constraints on non-profit corporations and concludes that even if PREMERA's compensation is reasonable before and after Conversion "a conflict of interest may exist" simply because higher compensation may be available in a for-profit New PREMERA. Cantilo & Bennett further cites the PwC concerns raised in their February 2004 Supplemental Executive Compensation Report, many of which lead to recommendations for greater emphasis on financial measures, margin, and shareholder return.

Towers Perrin Comment:

As Towers Perrin has noted previously, several of the PwC recommendations appear to be at odds with Cantilo & Bennett's concerns. In reading Cantilo & Bennett's report, we do not see any evidence to conclude that the prospects of such additional compensation influenced the Conversion decision.